

Keys To Carbon Neutral Oil And LNG Transactions: Part 1

By **Gabriel Procaccini and Kenneth Markowitz** (February 25, 2021)

In the dynamic world of oil and liquefied natural gas trading, one of the hottest new products is the carbon neutral transaction. Such transactions are designed to make oil and LNG more environmentally competitive with renewable energy, in response to environmental, social and corporate governance pressures, climate change and the decarbonization megatrend

Carbon neutral oil and carbon neutral LNG provide for the offset of the greenhouse gas emissions associated with a defined set of oil or LNG activities. A carbon neutral oil or LNG transaction is effected through terms in the underlying transaction documents that govern the sourcing, purchase and retirement of carbon credits as offset units, or COUs.[1]

In the case of LNG, carbon neutral transactions first emerged in Asia in 2019. Since that time, there have been several publicly announced carbon neutral LNG transactions, and other unreported carbon neutral LNG transactions. In the case of crude oil, Macquarie Group Ltd. arranged the world's first publicly announced carbon neutral oil transaction — a transaction executed by an affiliate of Occidental Petroleum Corp. for delivery of 2 million barrels of oil to Reliance Industries, announced on Jan. 29, 2021.[2]

The Biden administration is accelerating decarbonization rapidly through executive orders, as is an increasing number of the world's largest money managers through investment mandates. Moreover, with oil and LNG prices now trading at or near 12-month highs, the market for carbon neutral oil and LNG appears poised for explosive growth.

For participants seeking to enter into carbon neutral oil or LNG transactions — or for that matter, pairing offsets with other energy products — we recommend consideration of the following factors.

Incremental Cost of COUs, Allocation and Documentation

Converting a traditional oil or LNG transaction into a carbon neutral transaction involves incremental costs. The primary drivers of the incremental costs are the price of the applicable COUs, the applicable quantity of carbon dioxide emissions — and other GHG emissions, if any — to be offset, and the applicable quantity of oil or natural gas/regasified LNG in the underlying transaction.

Other factors that will influence pricing include:

- The quality of the COUs that the parties choose;
- The source or origin of such COUs — e.g., from a party's inventory, a registry or exchange;



Gabriel Procaccini



Kenneth Markowitz

- The definition of the carbon footprint that is applicable to the transaction; and
- Transaction costs (e.g., verification agent/carbon accountant costs, registry fees and other expenses).

For example, in the case of COU quality, price varies widely, with recent quotes from under \$1/metric ton of carbon dioxide to, in other cases, more than \$50/metric ton of carbon dioxide. Variables such as the type of project which generated the credit, the carbon standard under which the credit was generated, the location of the applicable project, the co-benefits associated with the project and the quantity of COUs bid by the buyer can all impact the price.[3]

During much of 2020, when global LNG and gas prices and proxies — e.g., JKM, TTF, Henry Hub, etc. — generally hovered at or below \$5 per MMBtu, this was a substantial additional cost, generally increasing the cost of a carbon neutral LNG cargo by 10% to 20% above the cost of a traditional LNG cargo of the same quantity without the carbon neutral wrapper.

However, with LNG prices increasing, and greatly outpacing the recent price increase in exchange-traded carbon dioxide emissions allowances,[4] the cost of pairing an LNG transaction with COUs has, in proportion to recent LNG prices, generally never been less expensive.

After determining the incremental costs, or pricing formula, that would apply in pairing the specific commodity with COUs, the counterparties must decide:

- Which party will bear the incremental carbon offset cost — seller, buyer or a third party via a pass-through mechanism, e.g., refinery, power generator or energy consumer;
- How to document the incremental cost and allocate it under the applicable master carbon neutral agreement, confirmation or annex to the underlying LNG or crude oil sale and purchase agreement; and
- How to document the quality and risks associated with the COUs.

For example, in connection with documentation, the parties will need to work with their advisors to weigh the potential risks of incorporating the terms and conditions of the carbon neutral transaction into the underlying purchase and sale transaction, versus documenting the carbon neutral portion of the transaction under separate and independent performance provisions.

In terms of pricing, the parties will need to evaluate whether to include the carbon offset cost formula within the oil or LNG pricing formula applicable to the underlying transaction, or whether to treat such costs as a separate line item in the cargo invoice or trade confirmation.

Whether the carbon offset aspect of the transaction will be binding on the parties at signing, or structured as an option — or perhaps subject to conditions precedent — will, among other things, influence these structuring considerations. Legal, tax, intercompany accounting issues and jurisdictional issues will also dictate the optimal approach.

In any event, while there are incremental costs in transforming a traditional oil or LNG transaction into a carbon neutral transaction, key players are betting that the downstream markets will develop such that premium pricing will be available for carbon neutral oil and LNG cargoes — and that such premium pricing ultimately will mitigate the incremental costs incurred by the parties to the original transaction, including incremental costs arising from any new regulatory compliance requirements.

Carbon Trading Regulations

Since the first voluntary carbon credits were traded in 1989, COUs acquired in the voluntary market^[5] have historically been sourced from registries established by nonprofit entities — e.g., Verra, a nonprofit established in 2005 to certify carbon emissions reductions — or acquired directly from third-party project developers, or through a party's sponsorship of projects which generate their own COUs.

Starting in March, the CME Group will launch its Global Emissions Offset, or GEO, futures contract, targeted toward voluntary carbon market participants, which will provide parties to carbon neutral transactions, among others, direct access to carbon offsets.^[6]

The CME GEO futures contract will be based on the Carbon Offsetting and Reduction Scheme for International Aviation, which includes carbon offset standards based on a set of criteria developed by the International Civil Aviation Organization, a specialized agency of the United Nations, and will allow for delivery of CORSIA-eligible voluntary offset credits from three ICAO-approved registries during specified delivery periods.^[7]

However, no matter how a COU might be sourced, traded or consumed, participants in a carbon neutral oil or LNG transaction should be cognizant of trading regulations applicable to COUs.

From a trading regulations perspective, COUs, as well as existing emissions allowances products, are generally deemed to involve "environmental commodities." These are treated in a similar manner as other tangible commodities that can be consumed — e.g., corn, soybeans, coffee, etc. — and on which a futures contract can be traded — such as the forthcoming GEO contract.

For transactions with a nexus to the U.S., subject to the exclusions described below, this generally means that the Commodity Futures Trading Commission, the primary governmental agency responsible for regulating the U.S. commodity derivative markets, would have jurisdiction over such transactions under the Commodity Exchange Act, or CEA.

Accordingly, except as noted below, parties to carbon neutral oil or LNG transactions would need to comply with the requirements of the CEA, including potentially satisfying commodity pool operator, swap dealer or other registration requirements, clearing the transaction

through a central counterparty and/or posting initial and variation margin, reporting the transaction to a swap data repository, and complying with other potentially burdensome and unexpected obligations, depending upon the structure of the carbon neutral transaction.

Indeed, the CFTC has indicated that if environmental commodity transactions are traded like stocks or bonds that are resold for their cash value, CFTC regulations would apply to such transactions just as they do to futures and swap transactions.[8] For example, a transaction involving the acquisition of COUs from the new GEO futures contract — as well as the trading of the futures contract itself — would be a transaction subject to CEA regulation and CFTC jurisdiction.

However, depending upon structure, a carbon neutral oil or LNG transaction may be excluded from regulations under the CEA. For example, forward transactions are generally not subject to regulation under the CEA and CFTC jurisdiction — other than the CFTC's general enforcement authority over anti-manipulation and fraud and deceptive trading practices with respect to cash commodities.

To qualify as a forward transaction, a contract generally must involve (1) an underlying nonfinancial commodity,[9] (2) deferred shipment or delivery of the nonfinancial commodity, and (3) intent on the part of the counterparties to settle the contract by physically making or taking delivery of the nonfinancial commodity. In our experience, the first two factors are generally able to be satisfied in carbon neutral oil and LNG transactions.

However, if COUs are not physically settled in a carbon neutral oil or LNG transaction — i.e., consumed or retired — but retraded, the forward exclusion would likely not apply, absent other exemptions, and the contract would instead be characterized as either a futures or swap contract subject to the regulatory jurisdiction of the CFTC. Other instances where the forward exclusion may not apply to contracts involving environmental commodities include where the transaction:

- Includes the right to unilaterally terminate the agreement under a prearranged contractual provision permitting financial settlement;
- Is structured as either a commodity option, including a trade option, or is embedded with volumetric or price optionality; or
- Is characterized as a retail commodity transaction.[10]

Accordingly, to minimize the risk of potentially onerous CFTC regulations applying to a carbon neutral oil or LNG transaction that the parties otherwise expected would have been exempt, those persons structuring carbon neutral transactions should consider these factors, including, among other things, striving to:

- Establish boundaries, or resale restrictions, that apply to post-closing activities associated with the COUs to minimize the risk that any resale of the COUs utilized in the transaction vitiates the forward exclusion and consequently triggers direct CFTC regulation; and

- Avoid carbon neutral transactions which permit the parties to financially settle the transaction in lieu of delivering or retiring the applicable COUs.

Advertising and Marketing

In the U.S., the Federal Trade Commission has been fairly aggressive in penalizing parties in the consumer goods industry that make broad, unqualified general environmental benefit claims such as "green" or "eco-friendly." As the FTC can initiate enforcement action if a marketer makes an environmental claim inconsistent with FTC guidelines, "carbon neutral," "low carbon" and "green LNG" or "net-zero oil" are all terms that may be subject to FTC scrutiny.

While none of the existing FTC marketing guidelines are explicitly related to carbon neutrality, the following FTC guidelines related to COUs may apply, since parties to a carbon neutral oil or LNG transaction use COUs to attempt to achieve neutrality or reduced carbon aggregate output:

- Marketers should have competent and reliable scientific evidence to support carbon offset claims. They should use appropriate accounting methods to ensure they measure emission reductions properly and do not sell the same unit more than once.
- Marketers should disclose whether the offset purchase pays for emission reductions that will not occur for at least two years.
- Marketers should not advertise a carbon offset if the law already requires the activity that is the basis of the offset.[11]

In addition, if a party states that it is "certified carbon neutral" by an accredited organization, that party would also need to meet criteria for endorsements provided in the FTC's Endorsement Guides, Title 16 of the Code of Federal Regulations, Part 255, including Definitions (Section 255.0), General Considerations (Section 255.1), Expert Endorsements (Section 255.3), Endorsements by Organizations (Section 255.4) and Disclosure of Material Connections (Section 255.5).[12]

To be certified, marketers must meet standards that have been developed and maintained by a voluntary consensus standard body. An independent auditor applies these standards objectively.[13]

For carbon neutral oil or LNG transactions that involve foreign jurisdictions, the parties must ensure compliance with carbon neutral marketing regulations applicable to those foreign jurisdictions.

Accordingly, when structuring a carbon neutral oil or LNG transaction, best practices would suggest the parties agree upon the applicable export, transshipment/reload and import

countries to ensure appropriate compliance with the marketing regulations in the applicable jurisdictions, or otherwise allocate potential liability for marketing claims occurring upstream or downstream of the core transaction to the counterparty best positioned to manage those risks.

For example, carbon neutral oil or LNG transactions with a nexus to Australia should be aware of Australia's National Carbon Offset Standard Carbon Neutral Program, or NCOS, and those transactions with a nexus to the U.K. should review the British Standard Publicly Available Specification for the Demonstration of Carbon Neutrality. The NCOS program provides that:

- To achieve carbon neutrality certification, an entity must measure its carbon footprint, reduce emissions where possible and purchase NCOS eligible abatement to offset the remaining emissions.
- Parties must also develop a plan for management of emissions which includes the management framework, systems and processes in place to effectively manage the carbon neutral commitment from start to end, as well as prepare a summary of emissions and actions under the program for public disclosure, all of which must be independently verified.

Given these risks, and the generally strong desire by the parties to publicly report the consummation of a carbon neutral transaction to, among other things, reap the public relations benefits of such a transaction and attain other co-benefits — e.g., satisfy ESG standards — it is especially important for the parties to ensure appropriate parameters are in place which govern the content of press releases, and to address public reporting and the sharing of information applicable to the carbon neutral oil or LNG transaction, so that any statements about carbon neutrality are highly defensible.

For example, in the case of the carbon neutral oil transaction referenced earlier, in recognition of the importance of this consideration, the parties defined their carbon neutral oil transaction to mean "a structured transaction that results in the offset of an amount of carbon dioxide equivalent to that associated with the production, delivery and refining of the crude oil and the use of the resulting product through the retirement of carbon offset credits," and net-zero oil to mean "oil produced by Occidental through the abatement of atmospheric carbon dioxide in an amount equivalent to the carbon dioxide associated with the production, delivery and refining of the crude oil and the use of the resulting product."^[14]

The second part of this article will consider the issues surrounding COU sourcing and quality assurance, and the processes by which the carbon footprint of transactions are measured.

Gabriel Procaccini is a partner and Kenneth Markowitz is a consultant at Akin Gump Strauss Hauer & Feld LLP.

Disclosure: Macquarie Group Ltd. is a client of Akin Gump, but the firm was not deal counsel in any of the deals mentioned in this article.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] In addition to carbon neutral transactions effected through COUs, some parties structure carbon neutral transactions through carbon capture solutions and technologies or ancillary carbon services in lieu of the use of COUs. Such transactions are also sometimes styled as "low carbon" or "green LNG" or "net-zero oil" transactions.

[2] Oxy Low Carbon Ventures, together with Macquarie, Deliver World's First Shipment of Carbon-Neutral Oil, Jan. 28, 2021, <https://www.oxylowcarbon.com/news/worlds-first-shipment-of-carbon-neutral-oil>.

[3] <https://secondnature.org/climate-action-guidance/purchasing-carbon-offsets-faqs>.

[4] Since Nov. 1, 2020, EUA (carbon emissions allowances trading on ICE Futures Europe) are up approximately 38%.

[5] While the voluntary carbon markets and compliance markets (e.g., the EU Emissions Trading System, California Cap-and-Trade Program, etc.) are interlinked, carbon neutral oil and LNG transactions generally rely upon credits made available in the voluntary market.

[6] Carbon emission allowances and related products, designed primarily for the compliance market, have traded for many years on various exchanges around the world, with a significant share of U.S. volumes traded on the Intercontinental Exchange, which lists futures and options connected to European and California carbon allowances, regional greenhouse gas initiatives and renewable energy credits. Participants in the compliance markets have utilized these exchange-traded products to effect or hedge compliance market transactions.

[7] https://www.cmegroup.com/media-room/press-releases/2021/1/26/cme_group_to_launchglobalemissionsoffsetgeofuturescontractonmar.html.

[8] Matthew F. Kluchenek, The Status of Environmental Commodities Under the Commodity Exchange Act, Harvard Business Law Review (Jan. 10, 2015).

[9] The CFTC has held that a "nonfinancial commodity" is a "commodity that can be physically delivered and that is an exempt commodity or an agricultural commodity." Exempt commodities are nonfinancial by nature.

[10] Such transactions consist of leveraged contracts involving a counterparty that does not meet the definition of an "eligible contract participant" or "eligible commercial entity" under the CEA, and physical settlement through actual delivery that does not occur within 28 days.

[11] See <https://www.ftc.gov/sites/default/files/attachments/press-releases/ftc-issues-revised-green-guides/greenguidessummary.pdf>. See also discussion of carbon offsets from Statement of Basis and Purpose (pages 59-74).

[12] See the FTC's Green Guides at 10.

[13] Id. at 12.

[14] Oxy Low Carbon Ventures, together with Macquarie, Deliver World's First Shipment of Carbon-Neutral Oil, Jan. 28, 2021, <https://www.oxylowcarbon.com/news/worlds-first-shipment-of-carbon-neutral-oil>.